IRAs Offer Nation Tax Windfall

Congress realizes that Medicare and Social Security lie directly in the path of a demographic tsunami. The first wave of baby boomers has already filed for benefits, and alarm bells are sounding on the Potomac.

But a little-noticed fiscal windfall kicks in just ahead. Starting in 2016, untold tax dollars will come streaming into the Treasury as boomers begin taking minimum required distributions (MRDs) from their retirement accounts. Legislators should speed up the distributions, and dedicate the proceeds to shoring up America's safety net.

The inflow traces back to the 1974 Congressional act that set up individual retirement accounts (IRAs). Numerous offshoots have been added, such as 401(k)s and 403(b)s, but the essentials remain what they were at the start. Contributions are tax-free and gains are tax-deferred. Withdrawals can begin at age 59 1/2; they must begin at age 70 1/2 and continue every year thereafter. Withdrawals, including capital gains, are taxed at ordinary income rates. (Roth IRAs, which have different rules, don't figure in here.)

The creation of IRAs was a political tour de force that served high social purpose, made economic sense, and appealed to separate self-interests. Through IRAs, the federal government offered millions of American workers their best chance ever to put away some money for the Golden Years. It was money that would let them live a little, not just get by on Social Security. What the government gave up in tax concessions, it could recoup on the other end: a continuous influx of extra revenue, topping off the glow of having done right by the country.

Corporate America cheered for its own reasons. Companies with defined-benefit pension plans quickly realized that defined-contribution IRAs gave them a less expensive way to offer a substitute benefit. Companies lacking pensions suddenly had a retirement plan as well, and it included the allure of potential stock market riches. Wall Street saw green. IRAs promised millions of new customers, endlessly handing over new money.

For the boomers—and for the Treasury—decades of tax deferral are drawing to a close and decades of MRDs are about to begin. As usual the devil is the details, and the details will pack real punch once the payouts get underway. Here are three ways Congress could alter minimum distributions to help shield the safety net from the demographic tides:

Set an earlier MRD date. There's no good reason to start MRDs at age 70 1/2. A meaningful start date would be age 65: when Medicare begins, so should the tax deferral payback. Congress acted a generation ago to protect Social Security by raising the retirement age in stages; today's Congress should act to help preserve Medicare by lowering the MRD start date, in stages, to age 65.

Adjust withdrawal rates. The starting MRD for most IRAs is less than 3.7 percent. Twenty-five years later, at age 95, it's just 11.6 percent. Congress should set the first-year MRD at 5% and recalibrate the rates going forward. Uncle Sam, generous all along, has strong grounds to accelerate account payouts. This step could be made progressive by keeping the current rates for balances below, say, $250,000.

Abolish "stretch IRAs". Several-generation transfers, now permitted, can extend MRDs into the next century. Passing along wealth is fine, but tax-sheltered retirement accounts shouldn't become tax avoidance tools. Set a two-generation limit, or a date-certain limit, after which balances must be distributed and taxes paid.

The power of these ideas is that they raise revenue without raising taxes. They're a stimulus as well: all the revenue comes from putting more income in taxpayer hands sooner. Money would flow in not only from boomer MRDs, but from all accounts taking minimum payouts.

President Obama has often called for shared sacrifice to help put America on sound fiscal footing. Few would find sacrifice easier than those with retirement accounts who willingly waive withdrawals until required, and then take only what they must.